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PACIFIC  **TELESIS**
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November 30, 1993

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William F. Caton
Acting Secretary
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Washington, D.C. 20554

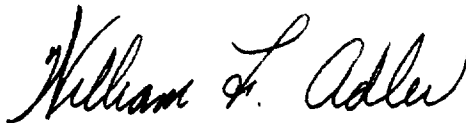
Dear Mr. Caton:

Re: *PP Docket No. 93-253 Implementation of Section 309(j) of the Communications Act, Competitive Bidding*

On behalf of Pacific Bell and Nevada Bell, please find enclosed an original and six copies of their "Reply Comments" in the above proceeding.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,



Enclosures

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of the Communications Act)
Competitive Bidding)
_____)

PP Docket No. 93-253

REPLY COMMENTS OF PACIFIC BELL AND NEVADA BELL

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Date: November 30, 1993

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SUMMARY

A number of parties submit alternative auction proposals. Many, particularly MCI, seek to gain a strategic advantage by the design of their proposed auction. It, and others suggest a combinatorial auction. Our experts, Professors Milgrom and Wilson, acknowledged auction authorities, explain why the Commission should reject combinatorial PCS auctions.

They have laboriously analyzed the other proposals. Their report, together with a step-by-step description of their auction design, is attached. They conclude that the combinatorial proposals are flawed because they fail to redress the "free-rider" problem. If that problem is not solved, the auction will be inefficient because licenses will not go to the bidders who value them the most.

The Professors also explain that a sequential auction is inefficient. It would allow for strategic behavior (behavior to either bias the system or exploit its biases) and limit the ability of bidders to employ alternative strategies.

After considering the comments, Professors Milgrom and Wilson have revised their proposed design with a closing/activity rule. Their revision reduces the ability of bidders to hold back - a type of strategic behavior - and moves the auction to closure at a reasonable pace in a reasonable time. The Commission must allow bidders sufficient time to react to auction events and to change strategies. The PCS auction will be complex and rushing it could be disastrous. The

Milgrom-Wilson design permits bidders to react to information but yet keeps the auction moving to closure at a reasonable pace. Their proposal - a simultaneous auction via repetitive bids for all broadband PCS licenses - is the best because it awards the licenses to the bidders who value them the most, eliminates the free-rider problem, and promotes the Commission's goals.

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PP Docket No. 93-253

REPLY COMMENTS OF PACIFIC BELL AND NEVADA BELL

Some commenters seek to gain a strategic advantage through the auction structure they propose.¹ On the other hand, our proposal - a simultaneous auction via repeated bids - developed by two acknowledged auction experts, Professor Paul R. Milgrom and Professor Robert B. Wilson, gives all bidders an equal opportunity to win. The Milgrom-Wilson proposal is fair to everyone because it provides the most information to bidders during the auction and therefore the most opportunity for bidders to base their decisions on accurate assessments of competing bids. Maximum information reduces the need for bidders to make guesses. In addition, the Milgrom-Wilson design minimizes the opportunity for bidders to manipulate the auction process. Guesses and manipulation reduce the efficiency of the auction and should be minimized.

¹ Perhaps the most glaring is MCI. Not only does MCI seek the advantage of a national combinatorial bid, but it brashly argues that it should pay only the second highest price! Its proposal is so transparently self-serving that it should be dismissed out-of-hand.

Professors Milgrom and Wilson have laboriously analyzed the proposals of other parties. Their report, ("Report") together with a step-by-step description of their auction design, is attached. They conclude that their design, with a modified bidder activity rule, is the most efficient because it will award licenses to the parties who value them the most, the "Highest Value Bidders."² The added activity rule ensures that the auction will be completed within a reasonable time. The auction must allow bidders sufficient time to assess the bidding, consult with superiors, and revise strategies. An auction conducted quickly could be a disaster because bidders would not be given enough time to react to events. In that case, losing parties would holler "foul" to the Commission, the press, and Congress and litigation would follow.

I. COMBINATORIAL AUCTIONS ARE INEFFICIENT.

A. Combinatorial Auctions Do Not Solve The Free-Rider Problem.

Different combinatorial proposals are suggested. MCI (p. 7), General Communications, Inc. (p. 14), and Bell Atlantic (p. 11) urge national combinatorial auctions. CTIA (p. 9) proposes limited combinatorial bidding; Nextel (p. 9) and NTIA advocate unlimited combinatorial bidding. Many parties oppose combinatorial bidding. Telocator says "combinatorial bidding mechanisms [are] fundamentally unfair and irrational" (p. 5) and

² Only if the Highest Value Bidder wins will the Commission's goals for PCS be achieved and will the greatest revenues be produced for the Treasury.

"a backdoor reintroduction of national service areas in the licensing of broadband PCS" (Telocator, p. 6). GTE argues that "combinatorial bidding [is]...de facto national licensing [and]...inconsistent with Congress' objective..." (GTE Summary). Sprint says "combinatorial bidding should not be implemented" (Sprint, p. 4). Their criticisms are valid. Every form of combinatorial bidding is defective. Every form encourages strategic behavior and creates a "free-rider" problem.³ Combinatorial bids are therefore inefficient because the Highest Value Bidders will not win, and combinatorial bids will not maximize revenues for the Treasury.

Professors Milgrom and Wilson described the free-rider problem in our comments: because individual bidders will refuse to bid their highest values for their individual items, the sum of the individual bids need not surpass the combinatorial bid (Pacific Bell, p. 9). Most of the commenters completely ignore this issue, an issue the Commission itself recognized.⁴ None that address it successfully resolves the problem.

MCI, General Communications, Inc., Nextel, and Bell Atlantic fail to address the free-rider problem. Their proposals are therefore fatally flawed and should be dismissed.

³ Assume bidder A's winning combinatorial bid is 10. Bidders B and C know this, and know what each needs to bid so that the sum of their individual bids exceeds 10. But there is no assurance that both will bid the necessary amount; A may hold back and try to have B carry a larger share; A is the "free-rider."

⁴ NPRM, para. 62.

Only CTIA and NTIA try to solve the issue, but they are unsuccessful.

CTIA and its expert, R. Mark Isaac, describe the free-rider problem in the NPRM's proposal. CTIA says "the free-rider problem here is quite real...." (CTIA, p. 22). CTIA and Mr. Isaac then say their alternative will solve this problem. Their approach is to announce the winning combinatorial bid and then conduct the individual auctions (Isaac attachment to CTIA, p. 14). This design does not eliminate the free-rider problem nor do CTIA and Mr. Isaac explain how it could.

Professors Milgrom and Wilson point out (Report, paras. 6-9) that in CTIA's scheme the burden of defeating the national bidder will fall disproportionately on the last bidders in the sequence. Early bidders in the individual rounds will bid low hoping that the later individual bidders will make up the shortfall, so that the cumulative bid of the individual bidders will exceed the national combinatorial bid. Professors Milgrom and Wilson conclude "the CTIA proposal compounds the problem of the original NPRM design by introducing both inefficiency and inequity into the auction design" (Report, para. 9).

NTIA makes the best attempt to solve the free-rider problem, and it is to be commended. It recognizes the defects in the NPRM's combinatorial bidding scheme and suggests an alternative - an "electronic iterative combinatorial auction" ("EICA"). It is similar to our proposal except for the

combinatorial feature which is unnecessary and preserves the free-rider problem.

Under NTIA's proposal, the electronic auction system uses a software program to inform the individual bidders of the amount by which each would need to increase its bid in order for the sum of the individual bids to exceed the combinatorial bid. Bidders could submit simultaneous electronic bids on any combination of PCS licenses, and they would be able to revise their bids in response to the bids of the other bidders (NTIA, pp. 15-16). This does not eliminate the free-rider problem for the reason we described about CTIA's proposal: one or more bidders (the free-riders) will not cooperate by increasing their individual bids; instead, they will wait and permit others to carry a greater share. As Professors Milgrom and Wilson state (Report, para. 14), some bidders may hold out in hopes that the other bidders will make up any shortfall.

We explained in our comments that the free-rider problem causes inefficiency because the party who values a license the most can lose the auction (Pacific Bell, pp. 6-7). That result reduces both social benefits and Treasury revenues. Combinatorial auctions are thus inefficient because they do not solve the free-rider problem: they do not award the license to the party that values it the most.

B. Combinatorial Auctions Are Not Necessary To Capture Value-interdependencies.

The argument in favor of combinatorial auctions is that they permit bidders to aggregate national or regional

licenses. Bell Atlantic claims "combinatorial bidding will allow the PCS market directly and fully to express the interdependence of license values...." (BA, p. 14); CTIA makes a similar argument (p. 11). Professors Milgrom and Wilson explain that a combinatorial auction is not necessary to capture value-interdependencies (Report, paras. 16-22) for two reasons.⁵

First, the secondary market will substantially protect the would-be combinatorial bidder from the risk of gathering only a fraction of the licenses it seeks. Second, combinatorial auctions are not necessary to capture value-interdependencies.

If a combinatorial bidder does not win all the licenses it sought, proponents claim it will have failed to have captured the value-interdependencies and will be stuck with licenses it may not want. This is incorrect. The secondary market will allow that bidder either to acquire other licenses or to dispose of the licenses it has. Because the winner will have bid only slightly more than the second highest bid to win, it can sell the license in the secondary market at no or only a small loss. Thus, the risk to combinatorial bidders is limited greatly by our proposal of a simultaneous auction using repeated bids (Report, para. 17).

Second, Professors Milgrom and Wilson (Report, paras. 18-22) point out that combinatorial auctions are not necessary to obtain value-interdependencies. They describe that roaming

⁵ Value-interdependencies are values which are derived from the relationship of one thing to another. For example, the value of one MTA license to a specific bidder may depend to some extent on whether or not that bidder can acquire licenses for adjacent MTAs.

agreements will permit the regional or national license bidders to fill in any service gaps and obtain the efficiencies of a regional or national service.

Our proposal permits bidders to capture any value-interdependencies that they believe exist: bidders can bid on any group of licenses they desire. But our proposal does not bias the auction structure one way or other - it puts all bidders on an equal footing. Neither the Commission, nor any commenter has explained or justified why the auction should favor combinatorial bidders. Put another way, there is no justification why the risks to combinatorial bidders should be any less than the risks to all other bidders.

C. Combinatorial Auctions Encourage Gaming The System Through Strategic Behavior.

Strategic behavior - behavior either to bias the system or to exploit its biases - reduces the efficiency of the auction. Combinatorial auctions encourage strategic behavior, and for that reason alone they should be rejected.

Each party who proposes some form of combinatorial bidding seeks to tilt the auction structure in its favor. MCI (p. 7), General Communications, Inc. (p. 14), and Bell Atlantic (p. 11) advocate national combinatorial auctions; CTIA proposes limited combinatorial bidding (p. 9); and Nextel (p. 9) urges unlimited combinatorial bidding.

Professors Milgrom and Wilson describe some strategic possibilities. One is recognized by all commenters. This is the incentive of a combinatorial bidder to refrain from bidding

on individual licenses. If the combinatorial bid eventually fails, this strategy impedes the auction because it prevents early revelation of this bidder's potential bids for the individual licenses, and it disguises the price that might obtain in secondary markets. Another strategic act is a large combinatorial bid (called a 'jump bid' in auction theory) intended to exacerbate the risk of the winner's curse for other bidders and to intensify the free-rider problem for bidders on individual licenses. A third is that bidders for individual licenses have an incentive to submit insincere bids for each other's intended licenses so as to drive up the other's price. A fourth (if AUSM were used) is the possibility that any bidder could confuse the operation of the queue of contingent offers by deluging it with thousands of such offers, making it difficult for participants to sort through the offers to find ones that might be acceptable.

D. Electronic Combinatorial Bidding Would Be Too Experimental.

NTIA suggests that computer software is available to use in a PCS combinatorial electronic auction. The software it suggests is "Adaptive User Selection Mechanism" ("AUSM") which has been developed by the Jet Propulsion Laboratory to assign scientific resources on the space station planned by NASA (NTIA, p. 17). NTIA says that the AUSM software could be used to implement its auction structure which allows for unlimited combinations of bids (NTIA, p. 17). But that software is too experimental to be used for PCS auctions.

Spectrum auctions are themselves "experimental" because the Commission has not conducted them before. Complexity and uncertainty should not be added to the situation by using experimental software developed for other purposes. AUSM was developed for a scientific scenario. The bidders are bartering with the attributes of a scientific project, such as size and weight. That software is not appropriate for an auction involving multi-million dollar bids for radio spectrum from which investors expect a reasonable rate of return.

Second, the AUSM software, to our knowledge, has not been thoroughly documented, validated, and tested in comparable auction settings. It is too risky for the Commission to rely on.

Third, the AUSM software will not be "transparent" to the bidders; they will be unable to perceive and verify that the AUSM software has correctly picked the winning combinatorial bids. That will produce confusion, disagreement, and probably litigation.

These flaws and the others we have described show that the costs of combinatorial auctions outweigh their benefits. The benefits of combinatorial bidding are in fact illusory and overstated. The costs, in terms of lost efficiencies, are real.

II. SIMULTANEOUS AUCTIONS ARE SUPERIOR TO SEQUENTIAL AUCTIONS.

Various parties suggest different sequences for the auction of PCS licenses. CTIA argues that license areas should be auctioned in descending order of population within a given

spectrum block (CTIA, p. 24). Nextel suggests that the largest BTA licenses should be auctioned first and then the largest MTA in descending order of population (Nextel, p. 8). Telocator says MTAs should be auctioned first and then BTAs (Telocator, p. 17). Bell Atlantic suggests holding four auctions based on the spectrum blocks (BA, p. 11). These are just a few of the sequencing suggestions; each one favors a particular bidding strategy over others. Sequential auctions are inherently biased, and they should not be used. Professors Milgrom and Wilson describe these biases (Report, paras. 23 to 35).

Sequential auctions force bidders to forecast what they may have to bid in one or more later rounds to complete a strategy. In the initial rounds bidders have to guess what the opportunities and prices in the later rounds will be (Report, para. 33). Thus, the sequential auction limits the opportunities bidders have to compare alternative strategies, and if one fails, try another.

NTIA identifies the principal flaw of a sequential auction: it will not adequately capture value-interdependencies (NTIA, pp. 10-11). A bidder in the early round will not know if it will capture a license in a later round. NTIA says "as a consequence, in a sequential auction, PCS licenses will not necessarily go to the bidders that value them most highly, and, as a result, economic efficiency will suffer. Furthermore, the government will not recover as much of the value of the spectrum as it would if it were to auction those licenses simultaneously" (NTIA, p. 11).

Sequential auctions will also take a great deal of time - perhaps a year - to complete. Professors Milgrom and Wilson point out that if it takes one hour to auction one license - a reasonable assumption - it will take 2,562 hours to license the 2,562 PCS broadband licenses (Report, para. 27). That's 320 business days or almost 1 $\frac{1}{4}$ years! That's unnecessary and inefficient.

The simultaneous auction via repeated bids designed by Professors Milgrom and Wilson is efficient. They have modified their proposal (based on various comments) to include a stronger bidder activity requirement. Their revised proposal is set out in their Report which contains a detailed step-by-step description of the auction. It is summarized below.

III. THE MILGROM-WILSON REVISED SIMULTANEOUS AUCTION SHOULD BE ADOPTED.

Professors Milgrom and Wilson propose a modified closing/activity rule (Report, paras. 46-56). The purpose of the rule is to reduce strategic behavior and conclude the auction within a reasonable time.

In their revision, each bidder would be required to bid actively at a level commensurate with its intended collection of licenses. The auction would be conducted in three phases. In Phase I, a bidder would be deemed active if it is active in bidding on at least one-third of the amount of

spectrum for which it is eligible to bid (Report, para. 53).⁶ Bidders that failed to participate at this level would have their future participation proportionately reduced. When the bidding activity has fallen to the point where the highest bid has changed on no more than five percent of the licenses offered, the auction would move to Phase II.

In Phase II, bidders would be required to be active on at least two-thirds of the amount of spectrum for which they want to remain eligible to bid (Report, para. 55). Once again, bidders that failed to participate at the required level would have proportionately reduced eligibility for future rounds. Phase III begins when the highest bid has changed on no more than two percent of the licenses being offered. In this Phase, bidders must be active on 100% of the amount of spectrum for which they want to remain eligible.

This structure would move the auction at a reasonable pace, and it would allow bidders to pursue either national, regional, or alternative strategies. If the auction occurs too fast, the results could be disastrous because bidders would be unable to react to events. The ensuing hew and cry from the losers would lead to litigation. The structure also reduces strategic behavior - behavior to either bias the system or exploit its biases - by requiring active participation. A bidder cannot hold back to gain information and then enter the contest. All sincere bidders must participate equally.

⁶ A bidder is active if it either has the highest current bid or submits a bid which exceeds the prior highest bid by the minimum set by the Commission.

Professors Milgrom and Wilson (Report, para. 59) reiterate the importance of identifying the highest bidders. This is valuable information. It assists bidders in determining the value of the licenses. When the highest bidder is known, others can judge how that bidder will use the license, and the others can make judgments on the value of the license. For example, a LEC will want to assess whether the leading bidder is a possible partner in forming a regional license or a go-it-alone national bidder. Information is critical to making informed value decisions; the more information available, the more likely the Highest Value Bidder will win. We explained in our comments how the Commission's goals are promoted when that bidder wins (Pacific Bell, p. 2).

IV. SPECTRUM SUBJECT TO AUCTIONS.

A. Point-to-Point Microwave Links Should Be Excluded.

Virtually all parties who address the treatment of microwave links agree that they should not be subject to auctions: AT&T (p. 15), BellSouth (p. 45), McCaw (p. 25), Southwestern Bell (p. 6), and Sprint (p. 22). Each makes the same argument. Because of frequency coordination, these are usually not mutually-exclusive applications. Therefore, this spectrum falls outside the auction authority. Pacific Bell and Nevada Bell agree.⁷

⁷ We support the proposal of Palmer Communications, Incorporated to grant tax certificates to Designated Entities for expenditures in relocating existing microwave users (p. 4).

We do disagree with the proposal of the Utilities Telecommunications Council ("UTC") that lotteries should be used for microwave links regardless whether or not there are mutually-exclusive applications. Lotteries will encourage trafficking. Parties will file applications in the hope of winning and then selling the license. Lotteries thus only serve to provide a windfall. As we and other parties said, frequency coordination is the best method to address point-to-point microwave usage in the 4 GHz, upper and lower 6 GHz, 10.5 GHz, and 11 GHz frequency bands.

B. The Spectrum Should Be Subject To Auctions If It Is Used For Service To Subscribers For Compensation.

AT&T endorses the NPRM's proposal that at least a majority of the anticipated use of the spectrum must be to subscribers for compensation to be subject to auctions (AT&T, p. 19). It rejects a "contamination" approach that if any service using the spectrum is for compensation, the spectrum is subject to auctions. UTC argues that spectrum used for mixed-use services should not be subject to auctions (UTC, p. 24).

These positions would lead to strategic regulatory behavior - behavior to either bias the system or exploit its biases - and administrative burdens for the Commission. Parties will try to gain an advantage over their competitors by avoiding an auction. They may try to use a majority of the spectrum for internal purposes, but use 49% to offer a service for compensation in competition with other providers. If successful, they will have a cost advantage over their

competitors. The competitors will file complaints with the Commission which will have to make the factual determination of the majority use. Litigation will ensue.

The Commission should reject their approach. Providers of like services should be treated similarly, as we described in our comments in GN Docket 93-252. An all-or-nothing test is fair to competitors who paid for their spectrum at auction, and it is easy to administer.

V. OTHER ISSUES.

A. Concerns About Collusion Can And Will Be Addressed.

The Commission expressed concern in the NPRM about collusion. Most parties that address this issue say the present antitrust laws are sufficient, and the Commission does not need to develop any new rules (e.g., Sprint, p. 19; AT&T, p. 39). We agree.⁸ The PCS auctions will garner extensive media coverage, and collusive conduct will be exposed. Also, collusive bidders will not have the ability to enforce their agreement because there will not be any subsequent auctions. With subsequent auctions, each party to a collusive arrangement knows that if it violates the arrangement in the first auction, the other party will take retribution in a later auction. Without the enforcement mechanism of subsequent auctions, a party will be

⁸ We do not agree with the statement of Alliance of Rural Area Telephone And Cellular Service Providers that bidders should be able to collaborate and share information and discuss bids (p. 7). Such activity would probably violate the antitrust laws. Only if parties are members of a consortium can they develop a coordinated strategy.

reluctant to collude because it will have no way to ensure the other party upholds its part of the bargain. Explicit collusion is thus highly unlikely.

Various commenters have also raised the spectre of implicit collusion among bidders. This too is unlikely provided combinatorial bidding is excluded and AUSM is not used. (AUSM allows bidders to submit contingent offers in a queue: these nonbinding and possibly nonserious offers allow communication that presents dire possibilities for implicit collusion). Bidders seeking to coordinate their strategies have the option of forming legal consortia, and therefore have little reason to engage in problematic tactics. Further, with as many as 200 bidders likely, and predictions that every metropolitan BTA and major MTA will attract at least a dozen bidders, implicit collusion will be greatly impeded by active bidding from many participants. With only the highest bid and the identity of the current high bidder revealed in each round, implicit collusion will be very difficult and extremely risky. Any attempt to refrain from bidding or to keep bids low offers many other bidders an opportunity to obtain the license with higher bids.⁹

On the other hand, if combinatorial bids are allowed, the risks of implicit collusion are substantial, and the results will pose serious consequences for the future structure of the wireless industry. The few national bidders could easily

⁹ The NPRM identifies the scenario in which a scarcity of bidders might allow implicit collusion, and for which a single sealed-bid auction would be used, NPRM, para. 38. The PCS auctions will involve many bidders so that risk will not be present.

coordinate strategies intended to exclude firms with regional strategies from acquiring any MTAs. In the extreme case, a duopoly consisting of two national firms could obtain two national licenses, each comprising a 30 MHz block A or B license in every MTA. This outcome would invariably lead to an inefficient outcome via higher prices for customers. Even if there are more than two national bidders, each would see the auction as a competition to see which among them would obtain the privilege of being one of the two dominant wireless carriers with national licenses. In view of the Commission's stated goal of efficiency, we see no reason that the auction design should encourage an outcome that favors national bidders whose winning bids are justified by the prospect of obtaining duopoly profits from dominant positions in an oligopolistic industry. The risk of implicit collusion pertains mainly to combinatorial bidding where it poses a severe risk of an unfavorable outcome that threatens the future competitive structure of the industry.

B. License Transferability Should Not Be Restricted.

The Commission should not impose restrictions on license transferability; it should encourage the secondary market. We disagree with the Utilities Telecommunications Council that restrictions on transfer are necessary (pp. 15-16).¹⁰ The deposit and up-front payments will

¹⁰ We support the argument of the Minority PCS Coalition that a Designated Entity should be allowed to transfer 49% of the license or the equity in itself to non-eligibles for the purpose of raising capital (p. 14).

discourage speculators, and therefore restrictions on transferability are not needed to prevent speculation.

Telocator supports the Commission's tentative proposal not to impose restrictions (pp. 14-16). We agree with Telocator's position and argument. There will be deficiencies in the auction which no one can anticipate. A fully functional secondary market is necessary to mitigate any deficiencies. It will allow parties to both sell and buy licenses to complete their strategies.

C. Rural Telephone Issues.

1. Rural Telephone Company's Proposal Should Be Rejected.

Rural Telephone Company ("Rural") proposes that designated entities should be able to obtain sub-licenses from primary licensees for areas with a population of less than 5,000 ("DE areas") at a price equal to the price paid by the primary licensee (Rural, p. 2). We do not endorse this proposal. It is inappropriate to impose price constraints on the value of a sub-license. The value determined at the time of auction for an MTA or BTA license should not control the value of a sub-license for a portion of the MTA or BTA in the secondary market. If the Commission imposes a price, it will discourage MTA and BTA licensees from entering into sub-licenses. Therefore, the Commission should reject Rural's proposal.

2. McCaw's Proposed Definition Of A Rural Telephone Company Should Be Rejected.

McCaw proposes a definition of rural telephone companies which would exclude only the twenty-one largest telephone companies from designated party status (McCaw, p. 20). It suggests that to obtain a preference as a rural telephone company, it must show that in combination with its parent companies and subsidiaries it provides service to less than 150,000 access lines.

That standard is too lenient. It would permit a telephone company serving a city with a population of 100,000 or more to qualify. That is not a "rural" telephone company. McCaw's proposal abuses Congress' intent to assist truly rural telephone companies,¹¹ and it should be rejected.

3. The Preference For Rural Telephone Companies Should Be Limited To Their Service Area.

The intent of the preference is to assist the rural telephone companies in their existing service area. Telocator says "there is no valid public policy reason for extending a bidding preference to a rural telephone company...on the basis that they happen to operate a rural telephone company in some other location" (Telocator, p. 11). We agree.

¹¹ Section 309(j)(4)(D).